

D.T.E. 02-27

Petition of Southern Union Company for authorization and approval to issue and distribute up to 10 million shares of common stock as a dividend payment to the Company's equity shareholders during 2002, 2003 and 2004 pursuant to the provisions of G.L. c. 164, §§ 11 and 14.

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FOR: SOUTHERN UNION COMPANY
Petitioner

I. INTRODUCTION

On April 16, 2002, Southern Union Company (“Southern Union” or “Company”) filed a petition with the Department of Telecommunications and Energy (“Department”) pursuant to G.L. c. 164, §§ 11 and 14 for authorization and approval to issue and distribute up to 10,000,000 shares of common stock as dividend payments to the Company’s equity shareholders during 2002, 2003, and 2004. There were no intervening parties. The Department docketed the filing as D.T.E. 02-27.

Pursuant to notice duly issued, the Department conducted public and evidentiary hearings at the Department’s offices on May 13, 2002. In support of its petition, the Company offered the testimony of Richard N. Marshall, Treasurer and Director of Investor Relations for Southern Union. The evidentiary record consists of 38 exhibits and eight responses to record requests. On May 20, 2002, the Company submitted a brief in support of its petition.

II. DESCRIPTION OF THE COMPANY’S PROPOSAL

Southern Union proposes to issue and distribute up to 10,000,000 shares of common stock as dividend payments to the Company’s equity shareholders for the years 2002, 2003, and 2004 (Exh. SU-1, at 2). Of the 10,000,000 shares, the Company intends to issue and distribute not more than 3,000,000 shares in 2002. Southern Union represents that the proposed 2002 distribution would be sufficient to provide for a five percent common stock dividend to shareholders, based on 54,686,048 common shares outstanding as of December 31, 2001 and allowing for additional shares that may be issued before the record date (*id.* at 3; Exh. SU-6, Tr. at 38-39).¹ The Company would issue and distribute the remaining 7,000,000

¹ While the stock dividend would not be applicable to outstanding shares held as treasury
(continued...)

shares during 2003 and 2004, and will certify the exact number of shares actually issued as part of a compliance filing (Exh. SU-1, at 5).

Southern Union explained that since 1994, it has had a policy of issuing a five percent stock dividend in lieu of a cash dividend (id. at 4; Tr. at 7).² Generally, the Company's board of directors meets in early June of each year to declare a dividend (Exhs. SU-1, at 4; SU-12).³ The Company's board of directors determines the stock dividend based on the percentage of outstanding shares of common stock as of the dividend payment date, as well as the record and payment dates (Exh. SU-1, at 4-5).⁴ The stock dividend is announced to shareholders on the declaration date and is paid to all holders of Southern Union common stock on the record date

¹(...continued)

stock, common shares that may be issued through the exercise of stock options and warrants would qualify for dividends (Tr. at 38-39). The actual number of shares required to pay stock dividends on options and warrants would not be known until the options and warrants are actually exercised (Exh. SU-29, at 16; Tr. at 38-39).

² The accounting treatment of stock dividends differ from the accounting treatment of cash dividends. When a company declares a cash dividend, retained earnings are reduced by the amount of the dividend (RR-DTE-7). When a company declares a stock dividend, retained earnings are reduced by an amount equal to the number of shares issued as a stock dividend multiplied by the market value of the company's common stock as of the dividend payment date (RR-DTE-7). A corresponding increase is made to the common stock account, up to the par value of the stock dividend, with any remaining difference booked to a premium on common stock account (Tr. at 69; RR-DTE-7).

³ In order to meet the requirements of G.L. c. 164, § 14, Southern Union intends to certify to the Department that the Company's board of directors has authorized the issuance (Exh. SU-1, at 4; Company Brief at 5).

⁴ By way of illustration, a stockholder owning 100 common shares of Southern Union stock would receive, in lieu of a cash dividend, an additional five shares (Tr. at 36).

(id. at 4).⁵ The payment date is set for approximately ten days to two weeks following the record date (id. at 5; Exh. SU-12).

For those shareholders who desire dividends in the form of cash in lieu of stock, Southern Union offers a Stock Dividend Sale Plan (“Sale Plan”), which provides eligible common stockholders the opportunity to sell those shares that they receive as stock dividends (Exh. SU-1, at 4; Tr. at 79-81). The Company states that the Sale Plan is administered by a plan broker who aggregates the shares and sells the shares on the open market over a period of several weeks (Exh. SU-1, at 4; Tr. at 79-80). The Company notes that shareholders participating in the Sale Plan are not charged for this service, and receive payment for their shares based on the average price obtained for the aggregated shares over the allotted time period (Exh. SU-1, at 4).⁶

Southern Union contends that the issuance of a stock dividend is in the public interest for two reasons. First, the Company argues that the payment of dividends in stock rather than cash constitutes a cost-effective means of attracting, acquiring, and maintaining equity capital for the funding of capitalizable additions, extensions, and improvements to its utility plant and property (Company Brief at 9, citing Exhs. SU-1, at 5-6, 9; SU-13). According to the Company, its practice of issuing stock dividends enables it to compete successfully in the capital markets by attracting investors who have a preference for stock dividends over cash dividends (id. at 12). Southern Union maintains that if it did not distribute stock dividends, and needed to

⁵ The record date is the date on which the shares must be owned in order to receive the dividend, and is usually set at about ten days following the declaration date (Exh. SU-1, at 4).

⁶ The Company represented that approximately 100,000 shares per year are exchanged for cash in this manner (Exh. SU-1, at 7; Tr. at 79).

preserve retained earnings to maintain a reasonable capitalization ratio, it would have to access the capital markets for additional equity at a greater cost, because of brokers' commissions and other issuance costs (id. at 13, citing Tr. at 41). The Company maintains that investors, rating agencies, and lenders have recognized the benefit of its stock dividend policy by providing Southern Union with more favorable debt terms than would otherwise be available (id. citing Tr. at 41).

Southern Union notes that because it is not drawing from its retained earnings to pay cash dividends to shareholders, the cash generated from these earnings remains available for reinvestment in utility property, plant and equipment (id. at 10). The Company analogizes this availability of funds to the objective of dividend-reinvestment plans that the Department has approved in the past for other utility companies, in that proceeds from dividend reinvestment plans are available to fund utility plant, and retire short-term debt (id., citing Berkshire Gas Company, D.P.U. 98-61/87, at 29-33 (1998); Essex County Gas Company, D.P.U. 96-121, at 5 (1997); Boston Edison Company, D.P.U. 94-150, at 6 (1994); Bay State Gas Company, D.P.U. 91-170, at 6 (1991); Colonial Gas Company, D.P.U. 91-130, at 4 (1991)). Furthermore, Southern Union argues that the distribution of a stock dividend to shareholders achieves the objective of a dividend-reinvestment plan in a more cost-effective manner for shareholders, because a shareholder is able to increase his or her investment in the Company without incurring the tax liability that is incurred when a cash dividend is received (id. at 10).⁷

⁷ Shareholders incur no tax liability associated with stock dividends until the stock is sold at some future date, which may reduce shareholder's tax liability associated with the dividend for the shareholder because of (1) the deductibility of the stock dividend in determining the tax basis of the investment and (2) a lower capital gains rate (Exh. SU-1, at 6; Tr. at 47-48).

Second, the Company asserts that issuance of shares for the purpose of distributing a stock dividend has an effect similar to a stock split, in that there is a gradual and predictable increase each year in the number of shares that are available to be traded in the marketplace (id. at 11). This, according to the Company, increases the liquidity and marketability of its stock (id. citing Exh. SU-1, at 6). The Company maintains that the Department has previously found that increased liquidity and marketability of a company's stock will lead to increased investment in the utility, thereby facilitating future financing at a lower cost to the benefit of the utility's customers (id., citing Fall River Gas Company, D.P.U. 93-147/93-172, at 7-8; Colonial Gas Company, D.P.U. 92-106, at 6-7 (1992); Fall River Gas Company, D.P.U. 87-160/87-193, at 3-5 (1987)).

Southern Union contends that a three-year term for its stock dividend issuance term is appropriate because of the complexity of the stock dividend process and added administrative process that would otherwise be necessitated if the Company were required to obtain annual approvals from the Department (Company Brief at 16). The Company argues that prior to the declaration of any stock dividend, it must coordinate its regulatory and administrative requirements of the New York Stock Exchange, Southern Union's transfer agent, and other involved parties (id., citing Exh. SU-12). Southern Union maintains that, in view of its demonstrated ability to meet the Department's standards on stock dividend issuances, it is unlikely that further annual reviews would result in a denial of the Company's request (id. at 17-18). Moreover, Southern Union states that the Department will have the opportunity to maintain oversight of the Company's financial practices through other filings, and that the Company will file annual reports with the Department detailing the actual number of stock

dividend shares issued, the level of retained earnings, and the status of the net plant test calculations (id. at 18).

III. CAPITAL STRUCTURE OF THE COMPANY

As of March 31, 2002, Southern Union's utility plant (including \$31,844,000 in construction work in progress ("CWIP")) was \$2,263,767,000 (Exh. SU-4 (Supp.) at 5). After removing \$812,358,000 in accumulated depreciation and amortization, the Company reported a net utility plant of \$1,451,409,000 (id.). In addition, Southern Union had \$84,801,000 of gas inventories and \$713,389,000 in acquisition premiums on its books (id.). Thus, as of March 31, 2002, the Company had a net utility plant and gas inventory balance of \$2,249,599,000 (id.).

As of March 31, 2002, the Company reported a total capitalization of \$2,060,527,000, consisting of (1) \$1,251,569,000 in long-term debt and capital lease obligations; (2) \$100,000,000 in preferred securities of a subsidiary trust, and (3) \$708,958,000 in common equity (id. at 6). The Company's common equity balance included \$38,258,000 in retained earnings, which the Company intends to reduce by the amount of the stock dividend, with corresponding increases to the common stock and premium accounts (Exhs. SU-16; SU-23; Tr. at 69-70).

Southern Union proposed a number of adjustments to these capitalization and net utility plant balances (Exhs. SU-1, at 10; SU-31). First, the Company excluded \$42,109,000 (\$59,775,000 in plant less \$17,666,000 in accumulated depreciation) from net plant in service to remove plant associated with unregulated operations (Exhs. SU-1, at 12; SU-4 (Rev.), at 5; SU-31). The Company made a corresponding reduction of \$42,109,000 to its total capitalization, based on a pro rata reduction to long term debt, preferred securities, and

premiums on common stock (Exhs. SU-1, at 12-13; SU-4 (Rev.) at 6; SU-31).⁸ Second, the Company excluded \$713,389,000 associated with acquisition premiums representing the excess of the purchase price over book value of several natural gas utilities acquired in recent years (Exhs. SU-1, at 13-14; SU-4 (Rev.) at 5; SU-31). The Company made a corresponding reduction of \$713,389,000 to its total capitalization, based on a pro rata reduction to long-term debt, preferred securities, and premiums on common stock (Exhs. SU-1, at 14-15; SU-4 (Rev.) at 6; SU-31).⁹ Third, the Company excluded from capitalization \$38,258,000 in retained earnings (Exh. SU-1, at 18; SU-4 (Rev.) at 6; SU-31). Finally, the Company eliminated \$31,844,000 in CWIP from its plant investment accounts, along with \$10,431,000 in gas inventories so that only gas held by Southern Union's regulated divisions was included in the total inventory balance (Exhs. SU-1, at 18; SU-4 (Rev.); SU-31; Tr. at 76-77). Based on these adjustments, the Company concluded that the excess of utility plant over capitalization as of March 31, 2002 amounted to \$185,035,000 (\$1,451,826,000 minus \$1,266,791,000) (Exh. SU-31).

IV. STANDARD OF REVIEW

⁸ The Company's unregulated operations have been supported over the years through a combination of debt and equity (Exh. SU-1, at 12-13).

⁹ The Company stated that it has financed its acquisitions over the years through a combination of debt and equity, and cannot directly attribute the acquired plant to specific capital sources (Exh. SU-1, at 12-13).

In order for the Department to approve the issuance of stocks, bonds, coupon notes, or other types of long-term indebtedness¹⁰ by an electric or gas company, the Department must determine that the proposed issuance meets two tests. First, the Department must assess whether the proposed issuance is reasonably necessary to accomplish some legitimate purpose in meeting a company's service obligations, pursuant to G.L. c. 164, § 14. Fitchburg Gas & Electric Light Company v. Department of Public Utilities, 395 Mass. 836, 842 (1985) (“Fitchburg II”) citing Fitchburg Gas & Electric Light Company v. Department of Public Utilities, 394 Mass. 671, 678 (1985) (“Fitchburg I”). Second, the Department must determine whether the Company has met the net plant test.¹¹ Colonial Gas Company, D.P.U. 84-96 (1984).

The Supreme Judicial Court has found that, for the purposes of G.L. c. 164, § 14, “reasonably necessary” means “reasonably necessary for the accomplishment of some purpose having to do with the obligations of the company to the public and its ability to carry out those obligations with the greatest possible efficiency.” Fitchburg II at 836, citing Lowell Gas Light Company v. Department of Public Utilities, 319 Mass. 46, 52 (1946). In cases where no issue has been raised about the reasonableness of management decisions regarding the requested financing, the Department limits its Section 14 review to a determination of reasonableness of the Company’s proposed use of the proceeds of a stock issuance. Canal Electric Company, et al., D.P.U. 84-152, at 20 (1984); see, e.g., Colonial Gas Company, D.P.U. 90-50, at 6 (1990). The Fitchburg I and II and Lowell Gas cases also established that the burden of

¹⁰ Long-term refers to periods of more than one year after the date of issuance.
G.L. c. 164, § 14.

¹¹ The net plant test is derived from G.L. c. 164, § 16.

proving that an issuance is reasonably necessary rests with the company proposing the issuance, and that the Department's authority to review a proposed issuance "is not limited to a 'perfunctory review.'" Fitchburg I at 678; Fitchburg II at 841, citing Lowell Gas at 52.

Regarding the net plant test, a company is required to present evidence that its net utility plant (original cost of capitalizable plant, less accumulated depreciation) equals or exceeds its total capitalization (the sum of its long-term debt and its preferred and common stock outstanding) and will continue to do so following the proposed issuance. Colonial Gas Company, D.P.U. 84-96, at 5 (1984).

Where issues concerning the prudence of the Company's capital financing have not been raised or adjudicated in a proceeding, the Department's decision in such a case does not represent a determination that any specific project is economically beneficial to a company or to its customers. In such circumstances, the Department's determination in its Order may not in any way be construed as ruling on the appropriate ratemaking treatment to be accorded any costs associated with the proposed financing. See, e.g., Boston Gas Company, D.P.U. 95-66, at 7 (1995).

G.L. c. 164, § 11 prohibits the issuance of stock for the purpose of issuing scrip or stock dividends, unless Department approval is obtained. While the statute does not articulate a standard of review to be used by the Department in evaluating petitions to issue stock for the purpose of scrip or stock dividends, the Department has previously determined that such petitions will be reviewed under the same standards as those set forth for the review of stock issues pursuant to G.L. c. 164, § 14. Southern Union Company, D.T.E. 01-52, at 6-8 (2001). Accordingly, the Department has determined that petitions filed under G.L. c. 164, § 11 will be approved if the proposed issuance is reasonable necessary to accomplish some legitimate

purpose in meeting a company's service obligations, pursuant to G.L. c. 164, § 14, and the company has met the net plant test, derived from G.L. c. 164, § 16.

V. ANALYSIS AND FINDINGS

A. Issuance and Distribution of Stock Dividends During 2002

1. "Reasonably Necessary" Standard

Southern Union has stated that its proposal to issue up to 10 million shares for purposes of issuing stock dividends would provide it with a cost-effective means of securing equity capital to fund additions, extensions, and improvements to the Company's utility plant and property (Exhs. SU-1, at 5-6, SU-13; Tr. at 40-42, 72-73). In order to maintain and support its current investment-grade credit ratings, Southern Union has embarked on a policy of decreasing its debt-equity ratio from 65.6 percent to 50 percent (Exh. SU-18; Tr. 73-76). The Department has found previously that issuing stock for the purposes of acquiring and maintaining equity, as well as financing plant improvements, is a "legitimate utility purpose" as contemplated by G.L. c. 164, § 14. Bay State Gas Company, D.P.U. 93-14, at 14 (1993); Colonial Gas Company, D.P.U. 90-50, at 6 (1990). Additionally, the Department recognizes that the payment of a stock dividend increases the number of shares that are available to be traded in the marketplace, which could enhance the liquidity and marketability of the Company's stock (Exh. SU-1, at 6). The Department has found previously that issuing stock for the purposes of increasing liquidity and marketability of a company's stock is also a "legitimate utility purpose." Fall River Gas Company, D.P.U. 93-147/172, at 7 (1993); Colonial Gas Company, D.P.U. 92-106, at 6 (1992). Accordingly, the Department finds that the proposed issuance of not more than 3,000,000 shares of common stock for the purpose of

issuing stock dividends during 2002 is reasonably necessary to accomplish a legitimate purpose in meeting the Company's service obligations in accordance with G.L. c. 164, §§ 11 and 14.

2. Net Plant Test

In regard to the net plant test, the Department requires companies to demonstrate that their net utility plant equals or exceeds their total capitalization pursuant to G.L. c. 164, § 16 Colonial Gas Company, D.P.U. 84-96, at 5 (1984). As noted above, Southern Union has proposed a number of adjustments to its actual capital structure. The Company has proposed to exclude CWIP from its plant investment balance and to exclude retained earnings from its capitalization. The Department has found previously that CWIP and retained earnings should be excluded from a company's plant and capitalization accounts for purposes of the net plant test calculation. Southern Union Company, D.T.E. 01-52, at 9 (2001); New England Power Company, D.P.U. 92-189, at 7 (1992); Colonial Gas Company, D.P.U. 84-96, at 8 (1984). Accordingly, the Department finds that Southern Union's adjustments for CWIP and retained earnings are appropriate.

The Company has proposed excluding capital for unregulated operations. The Department has found previously that the capitalization used to support unregulated operations should be excluded from capitalization. Southern Union Company, D.T.E. 01-52, at 9 (2001); Southern Union Company, D.T.E. 01-32, at 10-11 (2001). See also NYNEX Price Cap, D.P.U. 94-50, at 440 (1995); Colonial Gas Company, D.P.U. 84-94, at 51 (1984). Accordingly, the Department finds that the Company has appropriately excluded from its capital structure the capital used to finance unregulated operations.¹²

¹² The appropriate allocation of the Company's capital structure for ratemaking purposes
(continued...)

Similarly, the Company's proposed adjustment for acquisition premiums is appropriate, given that an acquisition premium, or goodwill, is intangible and, as such, should be excluded as a component in a utility's plant for purposes of G.L. c. 164, § 16. Southern Union Company, D.T.E. 01-32, at 11 (2001); New England Power Company, D.T.E. 00-53, at 8-9 (2000). Accordingly, the Department finds that the Company appropriately excluded acquisition premiums from its capital structure.

In calculating the net plant test, Southern Union included \$405,000,000 representing a 364-day term loan maturing on August 26, 2002 (Exhs. SU-4, at 16; SU-22; SU-27; Tr. at 16-17; 64).¹³ The Company explained that it included this note in capitalization because accounting principles require that the note be treated as "long-term debt - current portion" on the balance sheet (Tr. at 65). Regardless of how an item is required to be presented on a company's balance sheet for accounting purposes, the fact remains that the 364-day term loan has a maturity date of less than one year. The Department routinely excludes from capitalization debt instruments with a maturity date of less than one year for purposes of the net plant test. Southern Union Company, D.T.E. 01-52, at 9 (2001); Colonial Gas Company, D.P.U. 1247-A at 7, n.2 (1982). Accordingly, the Department finds that the 364-day term loan should be excluded from capitalization.¹⁴

¹²(...continued)

to its unregulated operations is best determined in the context of a rate proceeding brought under G.L. c. 164, § 94.

¹³ As of the date of the evidentiary hearing, the balance on the 364-day term loan was \$350 million (Tr. at 62).

¹⁴ Southern Union excluded its 364-day term loan from capitalization in its previous financing petitions filed with the Department (Tr. at 63-64). The Company states that
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In Southern Union Company, D.T.E. 01-32, at 13-14 (2001), the Department approved the Company's request for authorization to issue up to \$400,000,000 in long-term debt. Despite this approval, Southern Union has not yet issued this debt because the Company elected to file a "shelf registration" with the Securities and Exchange Commission, stating its intent to issue the debt within three years of the Department's approval (Exh. SU-26). The Company explained that the timing of the issuance will be based on an evaluation of the required proceeds, and the availability of advantageous short-term interest rates (id.; Tr. at 60). The Company excluded this debt issuance from its net plant test calculations. In prior proceedings the Department has determined that it is appropriate to include in the net plant test calculation debt that has been approved but not yet issued. Berkshire Gas Company, D.T.E. 98-61/87, at 32, n.14 (1998). Therefore, for purposes of this proceeding, the Department will include in Southern Union's capitalization the \$400,000,000 debt issuance approved in D.T.E. 01-32 for purposes of determining the Company's compliance with the net plant test. The authorization in D.T.E. 01-32 remains valid, albeit the indebtedness authorized remains potential rather than actual. Such an earlier authorization of potential debt, so long as it remains valid, cannot be ignored in later § 16 reviews.

The record demonstrates that, with the issuance and distribution of up to 3,000,000 shares of common stock in 2002, the Company's total capital stock and long-term debt will not exceed the Company's net utility plant following the issuance and distribution of the common

¹⁴(...continued)

the reason the loan was excluded from capitalization in prior cases was that the term note was entered into before the Department assumed jurisdiction over the Company (Tr. at 64). However, G.L. c. 164, § 16 makes no distinction between securities that were issued prior to Department jurisdiction and securities issued after the Department assumed jurisdiction over the issuing company.

stock (Exh. SU-31).¹⁵ Accordingly, the Department finds that the Company's issuance of no more than 3,000,000 shares common stock meets the net plant test as provided in G.L. c. 164, § 16. The Department addresses below the Company's request for authorization to issue and distribute the remaining 7,000,000 shares of common stock for the purpose of issuing stock dividends during 2003 and 2004 in Section V.B., below.

B. Issuance and Distribution of Stock Dividends During 2003 and 2004

As to Southern Union's request for authorization to enter into a multi-year stock dividend program, the Company maintains that it would be able to meet both the "reasonably necessary" standard and the net plant test for the years 2003 and 2004. However, the Company's ability to meet these requirements in those years is dependent upon a number of circumstances and events which cannot be ascertained at this time.

The requested § 11 approval of issuance of stock dividend raises potential complications that would not likely arise in ordinary applications of the §16 net plant test to other, §14 applications. For example, the market value per share of Southern Union's common stock at the time future stock dividends are declared would affect the Company's post-issuance capitalization balance for purposes of the net plant test.¹⁶ Another factor to be considered is the

¹⁵ Although Southern Union's total plant investment in Massachusetts is less than the amount of the financing sought, the Company's debt and equity financings are not specifically attributable to any particular jurisdiction (Exh. SU-1, at 12-13). Moreover, the Electric Restructuring Act of 1997 revised the definition of "gas company" to include non-Massachusetts corporations operating gas utilities within the Commonwealth. St. 1997, c. 164, § 189. Thus, the Company's combined operations are subject to the jurisdiction of the Department and the provisions of G.L. c. 164, § 14. Southern Union/Fall River Gas Company, D.T.E. 00-25, at 27 (2000); Southern Union/North Attleboro Gas Company, D.T.E. 00-26, at 26 (2000).

¹⁶ The amount of the reallocation of shareholder equity from retained earnings to par and
(continued...)

effect of one-time events on the Company's earnings.¹⁷ While the Department recognizes that there is an ebb and flow associated with the Company's year-to-year operations, this earnings variation renders it difficult for the Department to make a determination as to the propriety of approving stock dividends for the years 2003 and 2004. Ordinarily, this difficulty would not be expected to affect a § 14 application, where § 11 permission is not sought.

Although Southern Union contends that stock dividends provide it with a cost-effective means of obtaining equity capital by minimizing the need for debt financing, the Company conceded that equity financing is generally more costly than debt financing (Tr. at 40). The Company has not demonstrated that the cost of capital in 2003 and 2004 will be less by virtue of issuing a stock dividend versus debt financing. In future petitions for the issuance of stock dividends, the Company¹⁸ is required to present record evidence to support its claims that its stock dividend program actually results in a lower overall cost of capital.

Concerning the applicability of the net plant test to stock dividend petitions, the net plant test requires that the fair structural value of a company's plant be sufficient to support total capitalization after any proposed issuance of equity or long-term debt. See G.L. c. 164, § 16. This requirement has proved to be an effective tool in adequately evaluating traditional utility financings. However, the net plant test has certain limitations in evaluating a petitioner's

¹⁶(...continued)

premium accounts is dependent upon the per-share value of the Company's stock at the time of the transfer (Exh. SU-16).

¹⁷ By way of illustration, most of Southern Union's net income in 2001 resulted from a one-time gain from the sale of a portion of the Company's investment in Capstone Turbine Corporation (Exhs. SU-4 (Supp.); SU-20; Tr. at 23, 51; RR-DTE-3).

¹⁸ The requirement applies to all who would avail themselves of G.L. c. 164, § 11, as amended by St. 2001, c. 44.

request for authorization to issue common stock for the purpose of declaring a stock dividend, as is the case with Southern Union. As noted above, although stock dividends have no overall effect on a company's overall common equity balance, stock dividends result in a shift of equity from a company's retained earnings account to its par and premium accounts. This shift in capitalization has implications for a company's ability to meet the net plant test.

Although a company's par and premium accounts are included in capitalization for purposes of the net plant test, retained earnings are excluded from this calculation. Southern Union Company, D.T.E. 01-52, at 9 (2001); Colonial Gas Company, D.P.U. 84-96, at 8 (1984). See also Massachusetts Electric/Eastern Edison Merger, D.T.E. 99-47, at 63-64 (2000). If both a company's retained earnings and the value of its proposed stock dividend were greater than net utility plant not otherwise supported by its total pre-issuance capitalization, the company would be unable to satisfy the net plant test on a post-issuance basis (RR-DTE-7). Moreover, unless a company is able to increase its plant accounts in an amount no less than the aggregate par and premium account, it is possible that the company would eventually have a total capitalization in excess of its outstanding plant, and therefore fail to meet the Department's net plant test on that basis as well.

Based on our analysis, the Department has determined that the Company's ability to meet the standard of review depends upon circumstances and events which cannot be ascertained at this time. Accordingly, the Department finds that the Company's proposed issuance of up to 7,000,000 shares of common stock in 2003 and 2004 does not meet the standard of review as provided in G.L. c. 164, §§ 14 and 16. Therefore, we decline to approve the stock issuance prospectively.

C. Future Filing Requirements

Since the passage of Chapter 44 of the Acts of 2001, which repealed the per se prohibition against the issuance of stock dividends and authorized the Department to review petitions for authority to issue stock for the purpose of stock dividends, the Department has acquired further experience in how the issuance and distribution of stock dividends affect a company's operations. Based on our review in both this case and D.T.E. 01-52, the Department concludes that utility companies seeking to issue stock for the purpose of effecting stock dividends in the future must meet certain filing requirements. These filing requirements will facilitate the review of utility stock dividend petitions.

In future petitions for the issuance of a stock for the purpose of effecting a stock dividend, the Department will continue to apply our well-established two-prong standard of review applied to all petitions for the issuance of common stock, as found in G.L.c. 164, §§ 14 and 16. In considering whether a petition for authorization to issue stock dividends is reasonably necessary, the Department may consider, among other factors, the petitioner's annual earnings as compared to the market value of the proposed stock dividend, the cost-effectiveness of stock dividends as a source of capital, retained earnings balances (positive and negative), and the quality of the petitioner's earnings, including the source of the earnings and the extent that earnings result from non-operational transactions or activities versus utility operations.¹⁹

¹⁹ A party to a proceeding before a regulatory agency such as the Department has a right to expect and obtain reasoned consistency in the agency's decisions. Boston Gas Co. v. Department of Pub. Utils., 367 Mass. 92, 104 (1975). Application of these factors within our "reasonably necessary" analysis of § 11 petitions is heretofore unannounced. To apply these factors in the instant proceeding would deprive Southern Union of the reasoned consistency expected of administrative agencies. Therefore, the Department has identified those factors that will be considered in future § 11 proceedings only, not (continued...)

VI. ORDER

Accordingly, after due notice, hearing, and consideration, the Department:

VOTES: That the issuance and distribution by Southern Union Company of no more than 3,000,000 shares of common stock in 2002 as a dividend payment to the Company's equity shareholders is reasonably necessary for the purposes for which such issuance and sale has been authorized, pursuant to G.L. c. 164, § 14; and

VOTES: That the issuance and distribution by Southern Union Company of no more than 3,000,000 shares of common stock in 2002 as a dividend payment is in accordance with G.L. c. 164, § 16 in that the fair structural value of the Company's property, plant and equipment and the fair value of the gas inventories held by the Company will exceed its outstanding stock and long-term debt; and

VOTES: That the issuance and distribution by Southern Union Company of no more than 3,000,000 shares of common stock in 2002 is approved and authorized in accordance with G. L. c. 164 § 11, that allows for the distribution of a stock dividend after approval and authorization from the Department; and

VOTES: That the issuance and distribution by Southern Union Company of no more than 3,000,000 shares of common stock in 2002 is approved and authorized, contingent upon the Company's certification of a vote by the Board of Directors to authorize the stock issuance; and it is

¹⁹(...continued)
the instant proceeding.

ORDERED: That the issuance and distribution by Southern Union Company, in conformity with all the provisions of law relating thereto, of up to 3,000,000 shares of common stock in 2002 is authorized and approved; and it is

ORDERED: That the proposal of Southern Union Company to issue and distribute shares of common stock for the purpose of effecting stock dividends in 2003 and 2004 is DENIED; and it is

FURTHER ORDERED: That the Secretary of the Department shall within three days of the issuance of this Order cause a certified copy of it to be filed with the Secretary of State of the Commonwealth.

By Order of the Department

Paul B. Vasington, Chairman

James Connelly, Commissioner

W. Robert Keating, Commissioner

Deirdre K. Manning, Commissioner

DISSENTING OPINION OF EUGENE J. SULLIVAN, JR., COMMISSIONER

I. INTRODUCTION

I respectfully dissent from the majority's opinion authorizing Southern Union to issue a common stock dividend to its equity shareholders. The Company has not demonstrated that issuing a stock dividend is in the best interests of its ratepayers. Although the majority closely follows the guidelines established last year when we granted a similar request by this Company, circumstances have changed significantly since last year. I feel that this Commission has the obligation to consider factors beyond those established in D.T.E. 01-52 to determine whether the proposed issuance of stock is consistent with the public interest.

II. DISCUSSION

In 2001, the Legislature amended G.L. c. 164, § 11 to allow, with Department approval, the once prohibited practice of issuing stock dividends. Although the statute does not articulate a standard of review, the Department determined that a petition to issue stock for the purpose of paying a stock dividend would be reviewed under the same standards as a petition to issue stock generally pursuant to G.L. c. 164, § 14. D.T.E. 01-52, at 6-8 (2001).

Therefore, consistent with the Supreme Judicial Court's interpretation of § 14, in order to issue a stock dividend, a company must show that the proposed issuance is reasonably necessary for the accomplishment of some purpose having to do with the obligations of the company to the public and its ability to carry out those obligations with the greatest possible efficiency.

See Fitchburg II at 836, citing 319 Mass. 46, 52. Implicit in this analysis, I believe that a company must show that the proposed stock dividend is consistent with the public interest.

See Bay State Gas Company, D.P.U. 19886, at 11 (1979).

I dissent from the majority's opinion authorizing Southern Union to issue a common stock dividend to its equity shareholders because I do not believe that the Company has shown

that such an issuance is reasonably necessary and in the public interest. The Company argues that a stock dividend is necessary because its investors expect it. According to Southern Union, its investors are more interested in growth than in the payment of cash dividends, largely due to the favorable tax treatment accorded to stock dividends (Brief at 12). The Supreme Judicial Court, however, has recognized a distinction between actions that are reasonably necessary for a company's business and those that only benefit investors in a company's stock. Lowell at 52-53.

The Company also argues that the payment of a dividend in stock rather than cash provides it with a cost-effective means of attracting, acquiring, and maintaining equity capital (see Brief at 9). The Company asserts that the practice of issuing stock dividends reduces the Company's overall cost of capital (Exh. SU-1, at 3-4; Tr. at 40). The Company's policy of issuing stock dividends, in effect, substitutes equity for debt financing by minimizing the need for debt (Tr. at 40). However, the Company concedes that equity financing is generally more expensive than debt financing (id.). I believe, therefore, that the Company has not convincingly demonstrated that the cost of capital is less by issuance of a stock dividend, a form of equity financing, rather than debt financing.

The majority recognizes that the Department has acquired further experience in how the issuance and distribution of stock dividends affects a company's operations. To incorporate this experience in the future, the majority has outlined several "filing requirements" that all companies seeking to issue stock dividends must meet. However, the majority inappropriately relies on the doctrine of "reasoned consistency" to justify the future application of standards that they acknowledge are necessary. The requirement of reasoned consistency means that "any change from an established pattern of conduct must be explained, but it does not mean

that the Department may never deviate from its original position.” Town of Hingham v. Department of Telecommunications and Energy, 433 Mass. 198, 213 (2002), citing Robinson v. Department of Pub. Utils., 416 Mass. 668, 673 (1993). While I agree that the Department should consider these future “filing requirements,” I believe that this detailed level of review is necessary not only in the future, but also today. This detailed level of review is not grounded in any new standards, but merely a correct application of the public interest standard inherent in G.L. c. 164, § 14.

Southern Union’s common shares outstanding have increased by a multiple of five percent each year since 1994 (see Exh. SU-1, at 6). There is a very real possibility that the number of common shares outstanding may grow to such a huge number that the Company’s earnings would never be adequate to support the payment of cash dividends. Since the number of shares issued as part of Southern Union’s stock dividend program is not limited by net earnings, the Company does not have the same incentive as a company paying cash dividends to operate efficiently in order to lower costs and maximize profits. This could result in increased costs to the Company’s ratepayers. The procedures in place today for issuance of stock dividends may appear to offer sufficient safeguards and transparency to shareholders regarding their investment, but do not offer sufficient safeguards to ratepayers regarding the continued operational soundness of the Company.

Eugene J. Sullivan, Jr. Commissioner

Appeal as to matters of law from any final decision, order or ruling of the Commission may be taken to the Supreme Judicial Court by an aggrieved party in interest by the filing of a written petition praying that the Order of the Commission be modified or set aside in whole or in part.

Such petition for appeal shall be filed with the Secretary of the Commission within twenty days after the date of service of the decision, order or ruling of the Commission, or within such further time as the Commission may allow upon request filed prior to the expiration of twenty days after the date of service of said decision, order or ruling. Within ten days after such petition has been filed, the appealing party shall enter the appeal in the Supreme Judicial Court sitting in Suffolk County by filing a copy thereof with the Clerk of said Court. (Sec. 5, Chapter 25, G.L. Ter. Ed., as most recently amended by Chapter 485 of the Acts of 1971).

